



Forensic Focus on COVID-19

Financial statement fraud

This is the first in a Deloitte Forensic series around COVID-19 business impacts and steps you can proactively take to help respond to and recover from the outbreak and mitigate potential fraud and financial crime risks.

The coronavirus disease (COVID-19) outbreak has quickly advanced on a global scale and responses to it continue to rapidly evolve. The financial impact of COVID-19 will likely put enormous pressure on corporations' financial results and present potential challenges for individual employees. This pressure may increase the temptation for individuals to engage in improper acts in order to address their immediate financial needs or resort to financial statement manipulation to meet stakeholder expectations.

For some, as these financial pressures mount, the line separating acceptable from unacceptable behavior can become blurred. At the same time, controls such as segregation of duties may be weakened due to work force displacement or distraction. Organizations need to be

sensitive to the pressures that could result in financial statement manipulations at the corporate or operating subsidiary level. Further, management should recognize that the environment created by adverse events such as COVID-19 could lead to increased fraud by employees (e.g., asset misappropriation or bonus maximization schemes).

In particular, organizations should consider the following risks:

- **Overstatement of revenue**—To make up for decreased consumer spending, companies may endeavor to deliberately fabricate revenue to boost bottom lines and show how management was able to persevere in a challenging customer/business environment.

- **Understatement of allowances and reserves**—Companies have numerous valuation accounts, allowances, and reserves including—but not limited to—those for inventory, accounts receivable, insurance claims incurred but not recorded, income taxes, and contingent liabilities. Management may be motivated to intentionally manage these reserves to avoid additional charges to the bottom line.

- **Manipulation of valuations and impairments**—Organizations use forecasts as a key element in the valuation of assets such as inventory, goodwill, financial instruments, investments (such as portfolio companies and debt/equity securities issued by entities), and certain long-term contracts. Disruptions to supply chains and the volatility in financial

markets may result in organizational challenges to record such assets at their net realizable or fair values. Given the inherent uncertainty in valuing such assets in turbulent times, some companies may take advantage and consider intentionally delaying the recording of such losses or may attempt to overvalue certain assets in order to generate insurance recoveries.

- **Restructurings and “big bath” charges**—Given the strong probability of outbreak-related financial losses, affected companies may seek to write-off underperforming assets and/or record charges as part of larger organizational restructurings, sale, or closure of parts of their business that are either marginally associated with the impact from COVID-19 or not associated at all.
- **Capitalization of expenses**—It may be tempting for companies to capitalize expenses and deduct them over several accounting periods rather than expense them immediately. Outbreak-related costs may be substantial, and executives may be inclined to spread the costs out over a few years, rather than expensing them when incurred.
- **Disclosure fraud**—Companies may be motivated to avoid fully disclosing the impact of COVID-19 on its overall business results, particularly with respect to risks, uncertainties, contingencies, and representations contained in their public statements, and regulatory filings. For example, particular concerns may arise regarding companies’ or their counterparties’ ability to satisfy contractual obligations. The disclosure should also include an assessment of whether reliance on force majeure provisions or common law principles of nonperformance may apply. The adequacy and sufficiency of such disclosures may lead to claims of securities fraud by regulators and investors.

- **Margin manipulation**—Many companies are already experiencing significant decline in revenues, closures of plants, facilities, and storefronts, reduced transaction fees, and declines in assets under management, all while paying their employees and supporting current-state cost structures. Each of these actions increases the risk that an organization’s profit margins could be manipulated. There are many ways in which this can be done, but organizations should consider these risks and be aware of how it could happen at their company.
- **Pressures arising from “stock-drop” litigation**—Plaintiffs’ securities firms may seek to capitalize on stock price drops resulting from the crisis, leading to a slew of new case filings. Efforts to avoid costly litigation may lead to financial manipulation resulting in the misrepresentation of not only a company’s financial statements and disclosures, but also of key performance indicators in an effort to create “better than expected” operating reports.
- **Internal Controls over Financial Reporting (ICFR)**—The current economic environment may result in increased fraud risks related to internal controls. As many organizations move to a virtual work environment, there is a significant risk that fraudsters may find new ways to override existing internal controls, especially those critical to ICFR. Such controls may include, but are not limited to: segregation of duties, delegation of authority, and information systems access. With a potential decrease in workforce, the rapidly changing nature of working environments, and the possibility of changes in individual responsibilities, modifications to existing controls may not happen with the same speed, or new controls may be implemented without sufficient testing of their design and/or effectiveness. Accordingly, the nature, timing, and extent of diligence performed in a changing control environment create increased opportunity for fraud.

Should allegations surface regarding accounting/financial reporting misconduct and/or regulatory inquiries, it is important to seek assistance from an experienced team of forensic professionals dedicated to and well-versed in conducting extensive fact-finding financial statement fraud and corruption investigations using advanced analytics, digital forensics, and control remediation.

We’re here to help

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